



A French Voice for Laissez-Faire

e21 Staff Editorial | August 3, 2010

In a recent Financial Times op-ed, European Central Bank (ECB) president Jean-Claude Trichet called on industrial countries on “both sides of the Atlantic” to end fiscal stimulus programs and reduce budget deficits now. Trichet’s essay has commanded much attention because of his status as the second most influential economic policymaker in the world. But the underlying message and symbolism has been underappreciated: A French lifetime bureaucrat took to the op-ed page of an English language newspaper to defend free-market capitalism from his American counterparts.

There is an obvious fissure in global policymaking, most recently made clear by the Toronto G20 meeting. Industrial countries can be divided into roughly three camps: (1) those who believe large debt-funded stimulus offers the best chance of escaping from the current malaise; (2) those who have decided to embrace “austerity” measures to shrink their deficits and funding needs; and (3) those countries for which the question of additional stimulus is moot because the credit markets refuse to fund additional borrowing.

The U.S. is in the first camp. Its economic policymakers focus on the “lessons of 1937” when Congress, in their telling, pushed a recovering economy back into depression by closing a deficit that was 5% of GDP through spending cuts and tax increases.

The United Kingdom and Germany are in the second group. They could borrow at attractive rates to fund more stimulus, but prefer to embrace policies to narrow deficits.

Debt-ridden European countries such as Portugal,

Ireland, Greece, and Spain – the so-called “PIGS” – represent the third category.

[T]he basic assumptions about the efficacy of additional stimulus are wrong ... current market interest rates are hardly the best measure of how credit markets will view additional indebtedness in six, twelve, or eighteen months.

The proponents of the U.S. view generally frame the policy question in a way that leads to predictable answers. Is additional stimulus required? Will credit market participants buy the incremental debt issuance needed to finance it? The first question is nearly circular, as subpar growth and unacceptably high unemployment are the reasons the question about stimulus is asked in the first place. To answer the second question, these analysts generally focus on market interest rates. With 10 year Treasury yields below 3%, creditors’ willingness to fund additional stimulus does not seem in dispute. With the economy underperforming and credit markets open for more borrowing at low rates, the case for more stimulus seems open and shut.

The response from the second camp, as articulated by Trichet, is that the basic assumptions about the efficacy of additional stimulus are wrong and that current market interest rates are hardly the best measure of how credit markets will view additional indebtedness in six, twelve, or eighteen months. Trichet argues that the “experiences of fiscal consolidation episodes in less exceptional times” show that policies to reduce deficits can be consistent with robust growth. Trichet also emphasizes how quickly the market confidence that underpins current interest rates could unravel. After all, U.S. public

finances are hardly different from those of Spain, Ireland, or other countries for which the €750 billion stabilization fund was intended. At the very least, it is ironic that Paul Krugman cites low Treasury rates as evidence of America's ability to fund more stimulus while simultaneously ridiculing those who believe in the informational content of market prices. If markets are irrational, then we should take no comfort in the strength of the Treasury market, which could be a bubble poised to reverse itself without warning.

The financial collapse demonstrated the need for a systemic overhaul rather than establish clear guidelines ... the U.S. response was a convoluted package of future rulemakings and regulatory proceedings that will take years – if not decades – to resolve themselves.

While Trichet's position is "conservative" in the classic sense, as it represents the more risk-averse path, it is also conservative in the Reaganite sense. Trichet doesn't argue for tax increases to balance the budget. He believes "adjustment [should come] on the spending side, accompanied by structural reforms to promote long-term growth." To Trichet, consolidation's success or failure depends critically on how large the spending cuts are relative to the tax increases. Moreover, "structural reforms" is a classic euphemism for broad-based deregulation in labor and product markets to reduce the influence of labor unions, shorten the duration of unemployment, and allow free-market forces to set prices and wages.

Trichet's focus on spending cuts is a reminder of the debate in early 2009 when Republicans objected to the Obama Administration's stimulus proposal, calling it "a spending bill rather than a stimulus bill." President Obama ridiculed this line of thinking, asking rhetorically "what do you think a stimulus bill is? That's the point." Equating the stimulative effect of tax cuts and spending – or actually preferring

spending increases to tax cuts because of their higher "multiplier" – demonstrates a surprising fealty to old Keynesian models. While this kind of thinking could be defended if the specific government spending proposals increased productivity or added productive capacity, President Obama seemed to believe any spending would deliver immediate economic benefits. Also striking is the extent to which the Obama Administration concerns itself with the economic impact of layoffs at state and local governments. While these layoffs would result in a predictable decline in consumption, federal support for bloated payrolls is not cost-free and could actually reduce private sector investment in the states most in need of aggressive consolidation. Spending cuts can provide net economic benefits *today* by signaling to businesses and households that the cost of government will be less burdensome in the future.

Whereas Trichet emphasizes the need to couple spending reductions with "structural reforms" to improve competitiveness, the Obama Administration and its progressive allies in Congress are pushing an expansive new regulatory agenda, including the introduction of European-style labor market rigidities through "card check." The financial collapse demonstrated the need for a systemic overhaul and streamlining of the regulatory regime, but rather than establish clear guidelines on leverage, size, or margin requirements, the U.S. response was a convoluted package of future rulemakings and regulatory proceedings that will take years – if not decades – to resolve themselves. Similarly, the action on climate change thus far has been to eschew a clear, conspicuous tax on carbon emissions in favor of a labyrinth of regulations and cross-subsidies on energy use. The health care bill shares these other initiatives' inordinate complexity and regulatory overreach, but adds a layer of tax policy uncertainty because of the need to find a more reliable source



of financing for \$200 billion per year in new outlays than provided in the legislation.

It is no coincidence that those voices most in favor of additional government spending to support the recovery are also those most inclined to raise taxes, when necessary, to close the budget gap in the future. This fact is not lost on businesses and households, which is why additional stimulus spending can prove counterproductive. This is precisely the effect Trichet alludes to when he cites the previous “experiences” with fiscal consolidation. ECB research shows “curbing fiscal imbalances contributes to faster growth already in the short term” because it removes the uncertainty regarding future tax rates and the burden of government. Sharp government spending reductions cause businesses and households “to become more confident about the future; they start spending more, and the increase in their expenditure more than compensates for the reduction in government-led demand.”

As America presses for more and more government outlays to help the economy emerge from recession, a French bureaucrat cites the economic research of a European supranational body to advocate substantial reductions in government spending. Even odder is that the benefits of increased government spending have become conventional wisdom in Washington just as sentiment moves in the exact opposite direction in capitals Americans used to deride as “socialist.” America’s role in the current international economic policy debate should be deeply troubling for those who regard low taxes and free markets as the most reliable path to prosperity. The role reversal bodes ill for America’s long-run economic performance.